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B&B REVIEW

Corporate and Securities

Both Public and Private Companies Should be Reviewing Their Stock Option Grant Procedures

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INTRODUCTION

A crescendo of negative publicity continues to build on the timing of stock option grants by public companies prior to the passage of the Sarbanes-Oxley Act in 2002. A host of legal and accounting issues face public companies that engaged in practices such as back-dating, which became impossible when Sarbanes-Oxley shortened the reporting period for grants to two days, from year-end reporting. While public companies are focusing on their practices that are more than four years old at this time, private companies may also face legal and accounting threats from their own practices.

RISKS FOR PUBLIC COMPANIES AND EXECUTIVES

Public companies face several risks arising from the timing of option grants, not faced by private companies:

Disclosure Issues. Whatever is a company's past or present practice regarding the timing of stock options, if it is not fully disclosed in their SEC-filed documents those documents might be deemed to have be false and misleading. This could lead not only to enforcement actions but also to lawsuits by private investors. Forms 4 filed by executives also could be rendered inaccurate if accounting or tax issues require restatement.

Internal Controls Issues. In addition, if a company's practice regarding the timing of stock option grants was that there really was no set practice, thereby leading to the possibility of abuse, this might raise questions about the adequacy of a public company's internal controls over financial reporting. Sarbanes-Oxley requires that public companies maintain such controls and that their chief executive officers and chief financial officers certify as to their adequacy. If such certifications turn out to be false, there can be both civil and criminal penalties for the certifying CEO and CFO.

$1 Million Cap Under Section 162(m). Under Section 162(m) of the Internal Revenue Code, a public company's deduction for amounts paid to its CEO and next four most highly-compensated officers is capped at $ 1 million per individual, unless the compensation qualifies as "performance based". Stock options granted at less than fair market value would not be considered "performance based". If a company did not include in a prior year's corporate tax return income resulting from the exercise of such an option in calculating the $1 million cap, then it might have to amend the return if including such income would have caused the cap to be exceeded.

SEC Disclosure Regulations. The SEC has also stated that it may impose new disclosure requirements for stock option grant procedures in its forthcoming executive compensation disclosure regulations.

RISKS FOR BOTH PUBLIC COMPANIES AND PRIVATE COMPANIES AND THEIR EXECUTIVES

In addition to disclosure issues under the securities laws and internal control issues under Sarbanes-Oxley for public companies, stock option grant practices can raise a number of additional issues that could apply to both public and to private companies.

Accounting Issues. Until the recent adoption of FAS 123(R), option grants that were made at fair market value did not produce any compensation amount that had to be recognized by the employee or that could be deducted by the company. Grants that were made to take

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advantage of a lower stock price might be viewed as having been immediately "in the money" and as requiring immediate recognition of income by the grantee and immediate expensing by the company. Failure to have done so might require restatement of financial statements by the company and might render both company and executive tax returns inaccurate.

Other Personal Tax Issues. In addition to the general risk that an executive might have failed to report "in the money" stock option grants on his or her personal tax return, there might also be a risk under new Internal Revenue Code Section 409A. That section was enacted in late 2004 and imposes a new 20% excise tax on "deferred compensation", unless such compensation was under a plan that complies with Section 409A. The new law applies to amounts deferred after 2004 and to amounts deferred before that date if they were not vested by December 31, 2004.

It is somewhat difficult to grasp how an "in the money" option grant might be considered "deferred compensation". However, Section 409A guidance takes the position that a nonqualified stock option will be considered a form of deferred compensation if the exercise price is less than the fair market value on the option grant date, even if there are no other deferral features. While Section 409A does not tax deferred amounts that are payable on definite dates, such option grants are not likely to have set payment date arrangements.

The result of finding an option grant to have constituted "deferred compensation" would be that all amounts deemed deferred would become immediately taxable and the 20% excise tax would be imposed. This new tax is imposed only on the executive. Few plans or other executive compensation agreements require indemnification by employers of employees if such tax is indeed imposed.

Stock Option Plan Issues. In addition to the 409A issue described above, if there has been any deviation from the terms of the plan under which the options were granted, this might render the plan invalid for tax purposes. Such a result would have very negative consequences for both the company and the recipients of option grants. For example, incentive stock options might no longer be accorded the favorable treatment to recipients allowing them to defer recognition of income until the time of sale of the underlying shares.

WHAT TO DO NOW

Investigate Past Practices. All companies would be well-advised to undertake an immediate review of past option grant practices. "Practices" would include not only the process for routine grants but also the one-off-grants made from time to time. For example, a special grant to a senior executive receiving a promotion, followed soon thereafter by an increase in the company's stock price, might require some careful explanation and documentation.

For an investigation to have the greatest effect in a future proceeding, such as in an IRS or other regulatory inquiry, it should be undertaken quickly and by experienced professionals who were not involved, as grant recipients or otherwise, in the granting process.

Review Plan Documents. As noted above, if granting practice realities do not match the terms of plan documents, there could be adverse tax consequences. Experienced compensation counsel should review both plan documents and past and current practices to determine that they are consistent. Executives might wish to request that indemnification be added for taxes imposed under Section 409A.

Adjust Grant Timing Decisions. The safest course in granting options is to do so strictly on a regularly-scheduled basis. Meetings of public company compensation committees meetings should not be held during periods of time that participants in the granting process might have material inside information about the company that, once disclosed, could cause a movement in the company's stock price. For example, a relatively safe time to make option grants would be during the first quarter of a fiscal year, after public dissemination of the prior fiscal year's results.

This schedule approach would mean deferring grants for new hires until a regularly-scheduled meeting of the board compensation committee. However, if doing so would create unacceptable delays, then care should be taken to make sure that the company's stock price is not likely to change materially soon after the grant. The rationale for the grant timing should be contemporaneously documented in board minutes or otherwise.

Reexamine Stock Valuation Process. For private companies, the 409A issue described above highlights a broader concern that their process for determining what is "fair market value" must be defensible. The IRS has provided three safe harbors for determining fair market value which many private companies will attempt to meet when granting stock-based compensation. If the requirements of the safe harbors are met, then the IRS would have to demonstrate that the valuation method used was "grossly unreasonable".